THE TRANSITION FROM EXISTING CONDITIONS TO CENTRAL BANKING[1]

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IN organizing upon a new basis the banking system of a country as large as the United States, the problem of transition from the old system to the new is almost as important as the soundness of the new system. This problem of transition,—its dislocations, its difficulties and its costs,—is one which is too much ignored by the theoretical economist, perhaps in tariff matters as well as in those of finance. A transition, however, which may affect the activities, earning power and future calculations of a generation or even of a decade, looms larger upon the horizon of the people of that generation or that decade than the remote benefits to be attained by their successors when the transition is completed.

Upon the subject of finance, fortunately, it is possible to reason with more precision, from both theory and experience, than in some other parts of the economic field. In this field, as in the field of physical research, there has been great progress in recent years. The experience of such countries as Austria-Hungary, Russia and Japan in replacing irredeemable paper by a gold currency; the great experiment in British India in giving a fixed gold value to hundreds of millions of silver, supported by similar tests upon a smaller scale in Mexico, Peru and the Philippines; the success of Mr. Lidderdale, the governor of the Bank of England, in preventing a panic in 1890 by the simple process of coöperation to sustain confidence,—all these and other important events have taught the farsighted man of finance how far he can go in handling with courage and resolution the edged tools of gold, confidence and credit to accomplish given results.

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In dealing with the problem of banking reform in America, we have to deal with a problem of great magnitude, but one in all other respects comparatively simple. We do not have to struggle with a depreciated currency, as we did in 1875, nor do we have to face the depressing problem of locked-up and impaired assets, as did Italy and the Argentine when they undertook the reorganization of their banking systems. We have, moreover, an influence constantly working in our favor, in solving ugly problems of government paper and inflated bank-note issues, in the steady growth of our population and productive power and hence in our power of absorbing currency.

In dealing with the methods by which the power of note issue should be transferred from the existing national banks, above 7,000 in number, to a central bank with adequate branches, it is possible only to touch upon a few of the salient problems which present themselves. Thus far, less attention has been given to these problems than to that of the structure and operation of the proposed central bank itself. It cannot be expected that within the brief space of this paper an ultimate solution of those problems in all their details will be found; nor is it to be assumed that the suggestions here made are necessarily the best and final solutions. I have no doubt, however, that a method of transition from the old system to the new can be found which will permit the inauguration and operation of the central bank without jar to credit and confidence and without impairment of the interests and profits of the existing banks. That it can be found has been shown by the recent experiences of Sweden and Switzerland, both of which have transferred the power of note issue from local banks to central institutions, while leaving to the local banks their old powers as banks of discount and deposit. All that can be done in this paper is to point out the more important factors to be dealt with in solving the problem in this country and suggesting the broad outlines of a solution. Among these essential problems to be considered the following may be set forth:

1. The disposition of the two-per-cent bonds.
2. The disposition of the existing national-bank notes.
3. The relation of the existing national banks and other banks to the central bank.

4. The reorganization of the government currency.

I. The problem of the bonds is a serious one, but probably not so difficult as it appears, if it be attacked with a determined purpose to find a solution. The ultimate aim to be sought is to eliminate the bonds entirely from the banking business, except that perhaps a prescribed minimum might be left with the central bank as cover for the base line of its circulation, upon which the elastic element would be superimposed, adequately protected by gold. To retain bonds at all as a basis of bank circulation is not in accordance with scientific political economy, but dates back in practice to the organization of the Bank of England in 1694 and to its reorganization in 1844. Modern experience has shown that a certain amount of notes covered by assets not thoroughly liquid do comparatively little harm if they form only a moderate percentage of the total circulation and do not hamper the convertibility of the elastic element.

If the bonds were worth what the banks paid for them, they could be withdrawn by the banks as they surrendered their circulation and gradually distributed through the investment market. In the case of the 2 % bonds, however, which constitute cover for all but 6 % of the present bank circulation, value is derived largely from the use of bonds for this purpose. It would be necessary, therefore, in order to avoid heavy losses by the banks, to leave the bond-secured circulation untouched for a time or to provide that the bonds be taken over at par, or at some other fixed valuation, by an institution strong enough to carry them until maturity. If the latter course were decided upon, the function of carrying the bonds could probably be assumed by the central bank. It might be found advisable in any case to extend the process of substituting the notes of the central bank for those of the local banks over several years, and in the meantime outlets might be found for a part of the bonds by conversion or through other channels. If the central bank should assume liability for all the outstanding notes of national banks and should hold against them the bonds which the national banks now own, the notes would be protected by assets at least as flexible as under existing law and would have the

additional protection of the gold reserve of the bank and its great powers in the money market, derived from unity of resources and control.

A means of eliminating the bonds—or at least a large portion of them — within a comparatively short time, might be found in the postal savings system. There is little reason to doubt that this system will grow rapidly, once it has been fairly launched, and such a growth seems likely to occur several years before the central bank opens its doors for business. There may be a question whether the postal savings system in this country will so far supersede existing saving systems as to attain the rate of growth which has been reached in European countries. It is not unreasonable to believe, however, in view of the fact that savings deposits in the United States have grown during the past ten years at the rate of $130,000,000 per year, that the postal savings banks will get their share of the increment of progress and will soon be in a position to absorb annually many millions of securities. In Prussia, with a population little more than one-third of ours, and probably with a considerably lower scale of productive efficiency per capita, the five years ending with 1906 witnessed an increase in deposits in the savings banks of some 2,500,000,000 marks, or about $600,000,000. Figures like these indicate that if our postal savings system should prove at all attractive to the public, even in those parts of the country only which now lack efficient savings systems, the problem of getting rid of the bonds would be solved very soon after provision was made for their absorption by the people's savings.

In carrying out such a plan, there would be justification for a refunding operation which would correct the error of 1900 in seeking to float 2 % bonds at par, and would permit an interest rate to be paid which would give them a value near par as investments. If the secretary of the treasury were authorized to refund 2 % into 3 %, bonds only when they were presented by the postal savings bank, the teeth of criticism against an increase of the interest rate would be drawn by the fact that the toiling masses of the people were being put upon a level in the earning power of their small savings with the more fortunate investors in other securities.

II. The problem of getting rid of the existing national-bank notes is closely linked with that of eliminating the bonds from banking assets. There are several directions from which the problem of the notes might be approached. In some respects, the easiest path might be found along the precedent set by England in 1844 in careful respect for vested rights. If it were decreed that the national-bank circulation should stop where it is and that no bank in future should be permitted to take out an additional note, the field would at least be cleared for superimposing upon this dead weight the elastic element of issues by the central bank for future needs. If the principle of the English law were followed,—that whenever a bank liquidated, its power of issue should lapse,—there would be a steady downward movement of the old bond-based circulation while the upward movement of the total circulation due to expanding business was swelling the elastic element issued by the central bank.

The number of banks which have gone into voluntary liquidation since the organization of the national system has been 2,063, with gross capital of $356,542,900. The capital of banks liquidating during the past eight or ten years has shown an average of about $16,000,000 per year, which would be swelled by insolvencies to perhaps $20,000,000. The elimination of the notes of such banks for a period of ten years would have a perceptible effect in reducing circulation. If there were added to this provision the extension of the rule which is already law, that banks must retire circulation based upon bonds which have reached maturity, there would be an accelerating rate in the withdrawal of the old circulation which would soon reduce it to a negligible factor. This policy would have the merit of leaving the 2 % bonds to be provided for at the leisure of the government and the banks. They might no longer be required as a basis for the fixed circulation of the national banks, but might be surrendered *pro rata* over a series of years as an outlet was afforded for them in the postal savings system. Such a plan would probably necessitate a bank-note guaranty fund for the protection of the surviving notes of the national banks, but the creation of such a fund and its administration by the central bank would afford ample assurance against distrust of the old notes.

This plan represents the extreme of conservatism. It would probably be wiser to adopt a plan somewhat more radical for withdrawing the note-issuing power from the national banks. The desired result might be accomplished in a short term of years, at the rate of a fixed amount per quarter, as in the case of the new charter of the Bank of Switzerland. The National Swiss Bank went into operation in the summer of 1907, and it was provided that the circulation of the local banks then outstanding should be got rid of in three years by the surrender of one-twelfth of the amount quarterly. Notes not presented for retirement were covered by deposits of lawful money, as under our existing national banking law.

Such a process of reduction would not be difficult or embarrassing to the national banks if a market had been created for the bonds, either through purchase by the central bank with its own notes or by their absorption into the postal savings system, as above set forth. The central bank would undoubtedly be prepared to aid the local banks by advances and rediscounts, as was provided for in the recent reorganization in both Switzerland and Sweden. In the case of Switzerland, the National Bank made advances on bonds and other securities to facilitate the retirement of the notes of the local banks. In Sweden there were more specific provisions for aiding the local banks, to which reference will be made in discussing their relation to the central bank.

It is obvious that the existing national banks would suffer no embarrassment or loss if they received the notes of the central bank in substitution for their own, except the interest on the United States bonds which they now hold against circulation. The profit from this source is so small, and would be offset by so many advantages in the relations of the local banks with the central bank, that the loss of it would not impair the earning power of the local banks. On the contrary, the essential purpose for which circulation is desired would be served better than under the present system by the ability of the local bank to obtain currency up to any reasonable amount during the seasons when it was most required, by the simple process of rediscounting its good securities at the central bank and its branches.

Instead of being limited by a rigid rule or by the fluctuations of the bond market in its ability to obtain notes, the local bank would be in a position to meet the requirements of its constituents up to the limit of the aggregate of its first-class bankable resources. There would be no currency panics to be feared; there would be no occasion for piling up idle reserves, drawn from reserve agents in New York or Chicago under the menace of a fear that, unless currency were hoarded, it could not be had.

III. The problem of the relation of the local banks to the central bank would soon solve itself. Enough has already been said to indicate that their relations, instead of being competitive, would be mutually helpful. The central bank, dowered with a power of note issue which would be limited only by its ability to maintain adequate gold reserves through its influence over the international market, would stand ready to aid the local banks to the limit of their legitimate needs. The local banks, at least during the period of transition, might be accorded some of the special privileges which were granted to them in Sweden, where a credit was opened in their favor against approved collateral at a rate 2 % below the published discount rate, and power was granted to obtain rediscounts at a rate not exceeding two-thirds of the published rate. Reserve requirements for the local banks might be made less onerous than at present, on condition that they kept the notes of the central bank in reserve vaults.

In putting into execution a more flexible system of credit than that which the country now possesses, it would be necessary to extend the practice of acceptances, which has been so ably presented to the country and to this academy in the papers of Mr. Paul M. Warburg. The adoption of this system would come about naturally when it appeared that the central bank would grant accommodation readily upon accepted paper and preferred to take it when it had partly matured rather than immediately after its creation. The gradual extension of the system of acceptances, especially in foreign trade, would give genuine convertibility to commercial assets which now too often represent a security acceptable only at the institution where it is first discounted. Foreign bills, moreover, would become an

available part of the real reserve of the central bank, because they would meet the demands for the export of capital or for gold resources at London, Paris or Berlin in times of pressure.

IV. It remains to refer briefly to the share which the central bank would be able to take in restoring to a modern basis our clumsy system of government currency. It would be a legitimate duty of the bank to assume the current redemption of the greenbacks. If the government should turn over to the bank its reserve of $150,000,000 in gold, the bank would need no other asset against the $346,000,000 in outstanding greenbacks except the liability of the government for their ultimate redemption. If the bank notes and the greenbacks were thus disposed of, it probably would not be necessary to provide for direct redemption of silver certificates in gold. They would float of themselves as a substratum of token money, representing a constantly diminishing ratio to the whole amount of currency in the country. In the case of the gold certificates, the government would hold the gold for their redemption until their retirement, but it would undoubtedly be wise to prohibit further issues, in order that the free gold of the country might gradually sift into the metallic reserve of the central bank as a guarantee for its outstanding notes. At first, no doubt, there would be a disposition among the old banks to discriminate in favor of gold certificates for their own reserves, but as they needed them from time to time for paying customs duties and for other large payments, the tendency of the outstanding total would be downward, and several hundred millions of the $900,000,000 in gold held against them would become a part of the great mass of yellow metal which would contribute to the impregnable reserve of the central bank.

Such, in outline, appear to be the proper solutions of the leading problems of transition from our existing system of isolated banking units, fighting among themselves in times of panic, like the demoralized passengers of a sinking ship, to the system of coördination, unity of control, and mutual protection which would be involved in the operation of a central bank of issue.